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Aug. 23, DJIA 1318.32; PTI 1921; A-D Ratio -14.38
Aug. 30, DJIA 1334.01; PTI 1934; A-D Ratio -14.02

THE MARKET: The single most difficult concept to get across to investors (and I say this after twenty-eight years of writing about it) is the concept of the great primary trend of the market. A primary trend, bull or bear, once set in motion, does not reverse until it is EXHAUSTED. A bull market such as this one, for example, will not top out until the bull forces have totally spent themselves. Thus, a bull market will not die on bad news, it will not collapse on Presidential heart attacks, economic recessions, corporate disasters or political threats. A bull market will only end when the internal bullish forces have exhausted themselves and there is nowhere to go but down. When that happens, when the next bear market begins, all the shorting, all the Fed monetary flooding, all the Congressional hoopla in the world will not turn the bear market around.

For instance, here in August 1985 economic news is anything but glowing. Machine tool orders (a harbinger of the economy) fell 36% in July. Major companies are announcing major lay-offs. Durable goods orders are down. Housing starts in the Northeast (which up to now has been the best area in the US for starts) are down 31%. And executives at the recent Advertising Age Creative Council warn that advertising has leveled off and will head down next year. US farming is in a depression and currently has $100 billion more debt than it can handle. You want more? The Treasury has just announced that the Federal deficit was $20 billion in July, up from $16.4 billion in July, '84. Thus a $200 billion deficit is in the bag for 1985-86.

Now from a cold, selfish, market-oriented standpoint, I don't give a damn about all that bad news. What I am interested in is the market's reaction to the news. In a bear market, the kind of news sketched above would send the stock market careening lower. In a bull market, Wall Street will tend to stand its ground while the ghastly news is being absorbed. Or at worst, the stock market will back off to protect itself and maybe sink into a secondary reaction.

From the market technician's standpoint (and MOST of them still don't understand this) when a bull market is in force, a technical build-up (i.e., rising short interest, increased odd-lot selling, bearish sentiment rising, etc.) is an extremely healthy development. Such a build-up within a bull market will, in time, send the market sharply higher. But if a bear market is in force, all the technical build-up in the world will simply POSTPONE the timing of the next major decline. Technical plusses don't end a bear market. As I said before, downside exhaustion is what puts the bear back in his lair.

Despite what you read in the advisory advertisements, despite what you hear from your broker, despite what your uncle on Wall Street tells you, investing is a business of probabilities--not certainties. In the investment business, the amateurs demand certainty, the veterans and professionals are resigned to probabilities.

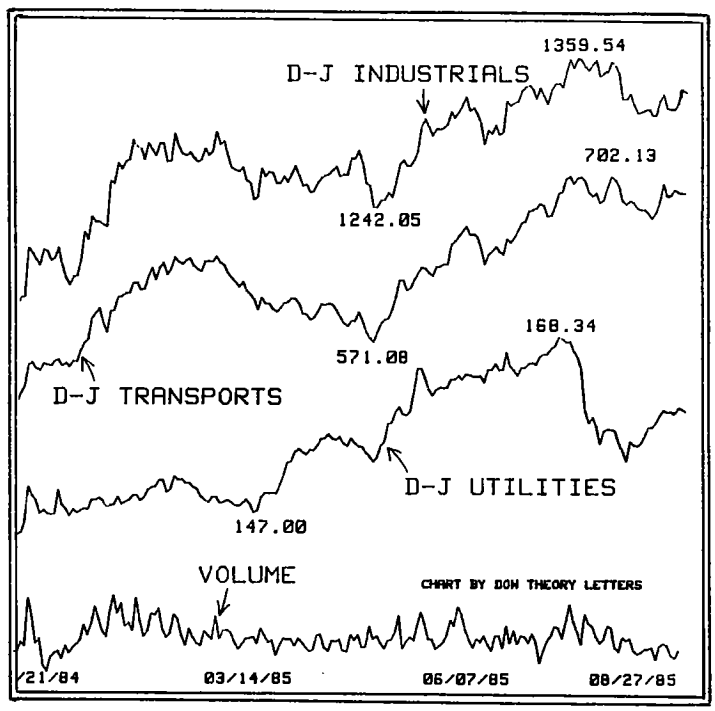
In the last few Letters I stated (1) that the PTI was acting extraordinarily well, but that (2) the PTI was also quite extended on the upside, and (3) that I felt that the market could be near a secondary reaction.

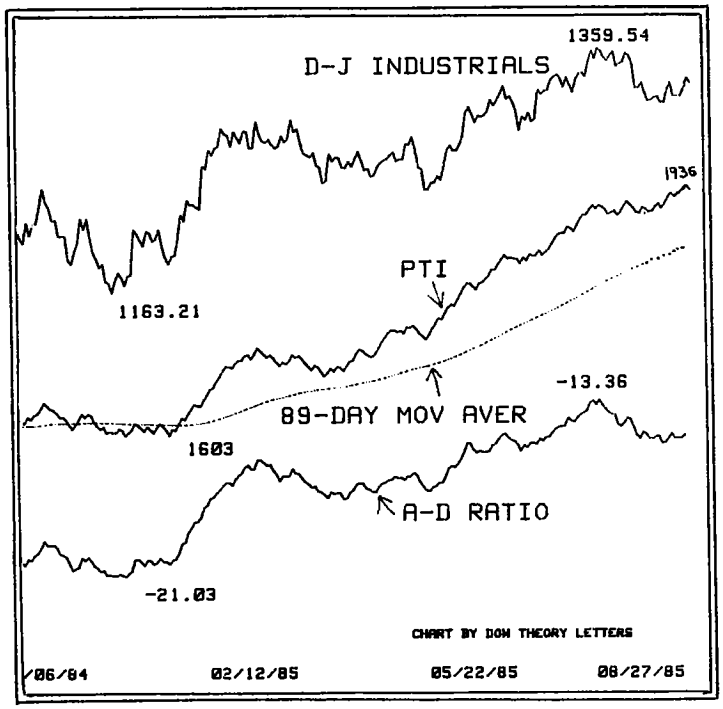
In view of the successive new highs in the PTI (a record high of 1931 on August 28), isn't it paradoxical to think that the market could be heading for a correction? Maybe so, but I want to present a few of my worries at this time (don't get me wrong, I am not suggesting selling stocks in view of the strong PTI, but I am advocating caution and a wait see attitude).

Note on the page 2 chart that the main mass of stocks, as gauged by the advance-decline ratio, has lagged. Furthermore, the list of daily new highs (NYSE) has dropped dramatically. All this is just another way of saying that upside momentum in this market has subsided. The market appears tired.

Now it's one thing for the market to be tired, and it's another to expect a correction. So what reason do I have for expecting a correction in the period ahead?

The answer (and remember, we're dealing in probabilities) is seen in this page 2 chart (chart





courtesy of Davis Research--PO Box 2089, Venice, Fla.). Here we see a chart which shows the percentage of NYSE stocks holding above their 30-week moving averages.

Dan Sullivan, editor of the Chartist (Box 3160, Long Beach, CA 90803) refined this study in that he made the following observation. Over the past 16 years every time this index has risen above 80% (into over-bought territory) and then dropped below 60%, the index has continued down to the 30% area or below. There are nine such instances, and I have numbered them on the chart. In other words, this index (so far) has a perfect record in that a rise to above 80% and then a drop below 60% has taken the index down below 30%. How far below 30%? There's no way to predict. In some cases the index dropped just below 30% as the market merely corrected an over-bought situation. In other cases (such as in 1972 at point #3) the market went into a severe bear market collapse.

All right, let's turn to the current situation. In February 1985 the index rose to 84%. The index then turned down sinking to 64% in March. A new rally took the index to 72% in July. But in late July the index finally broke decisively below the 60% level--to 56%. The probabilities based on case histories going back to 1967 now say that the index should sink to below 30%. But how much below 30% no one knows.

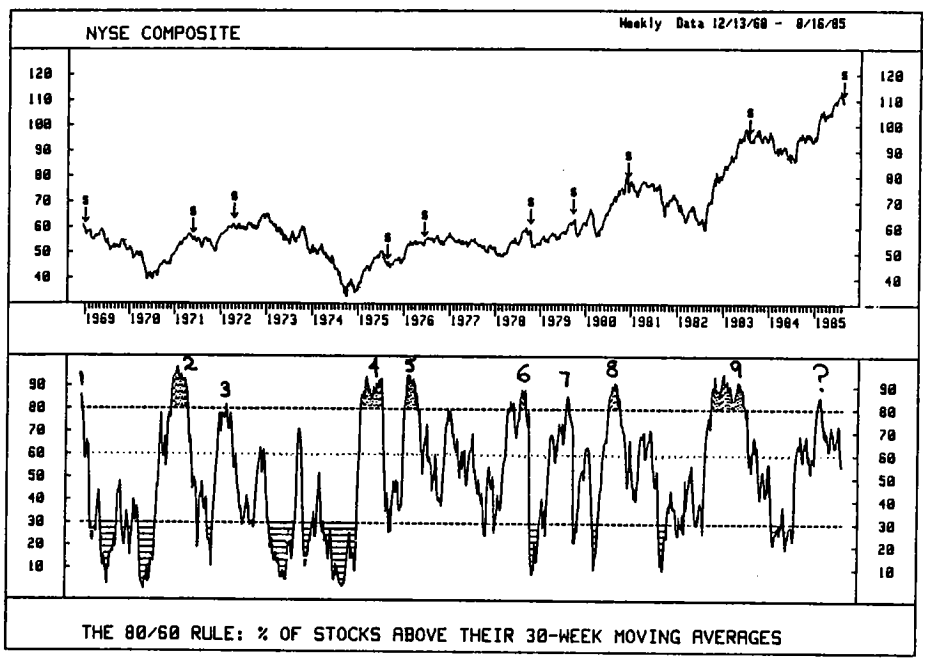
So this is how I see the picture. As long as the PTI continues to climb any correction will be held off. A climbing PTI means either a rising market or (at worst) a sideways market. But when the PTI finally does turn down, I would be watching very closely for a secondary correction. Such a correction could take the majority of stocks (70% if the 80% - 60% rule holds) below their 30-week moving average).

Question: Russell, if the percentage of stocks holding above their 30-week moving average does drop below 30%, how can you write off the possibility of a very severe reaction or even a bear market?

Answer: The purpose of all reactions in bull markets is to dampen the enthusiasm of wild-eyed speculators and greedy bulls. The market can accomplish this in a number of ways. It can produce a violent decline. Or it can produce a long, dragged out shallow correction. Or it can produce a complex, trading range-type correction. But all corrections serve the same purpose. They let the steam out of the market boiler. And in many cases, corrections are the market's way of discounting recessions that come within a continuing long-term bull market.

Question: All right, what kind of corrective action would you envision in the period ahead?

Answer: My guess is a shallow correction at first, but perhaps with a scary drop towards the end. In terms of time, since this correction has been going on since July (or since February if you take the peak of strength in the 30-week index as seen on the chart), I would guess that the corrective action should end around October or maybe November.



Question: Russell, from time to time you have quoted the Levy's "Industry Forecast" out of Chappaqua, NY. They have been big bears on the economy. Have they changed their minds?

Answer: They most certainly have not. Their latest report, received August 26, is as bearish as before (and remember, these fellows have an excellent record). Here are a few excerpts: "The fall in corporate profits, which is accelerating, will become steeper and continue at least until the third quarter of 1986 . . . Inflation wll moderate further and the economy will become much weaker than almost anyone expects . . . Sales will continue to fall below stores' expectations. The Christmas

shopping season is likely to be a disaster."

So one widely-watched and quoted source sees major trouble ahead for the economy and the government (the Levys see a possible $300 billion Federal deficit by late-1986). And the stock market is well aware of the Levy's warnings. So let's watch the market's reaction to the coming economic problems.

It all reminds me of something Robert Rhea wrote years ago to the effect that you may know all about tomorrow's news, but you can never know how the market will REACT to that news.

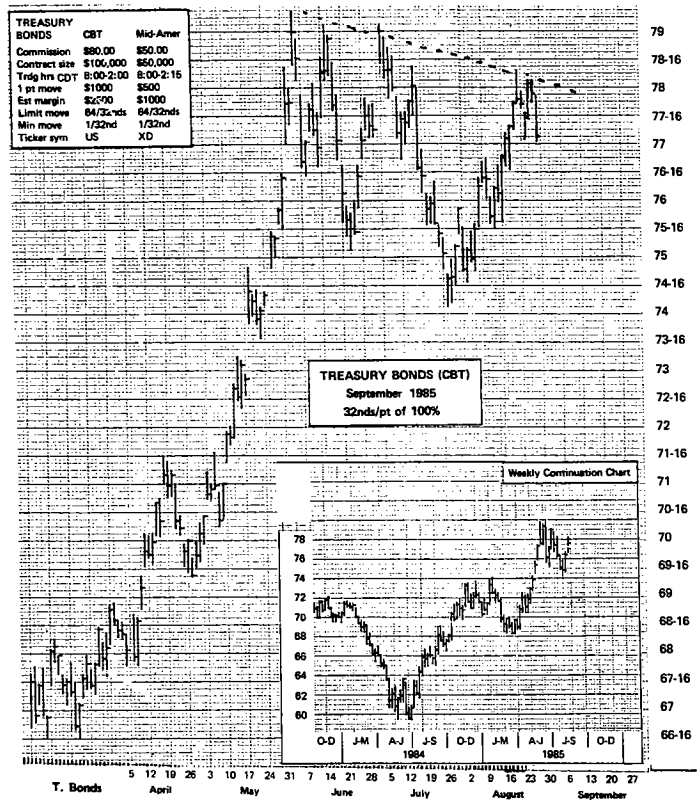
INVESTMENT POSITION: The bull remains firmly in the box, and I personally am standing pat with my bond and stock positions. There's plenty of unpleasant economic news out there, but the stock market is no idiot--it's digesting the news and (so far) holding fast. The PTI continues to amaze me with its strength.

Exxon, Westinghouse, Owens-Illinois, and Woolworth (all on my "strong list" for months) have been outstanding performers. But today the public is buying its head off in income vehicles. The items they like are no-load bond funds and Ginnie Mae funds. As I have been saying, INCOME is going to be the key word for the rest of the '80's. (Item: since 1981 family income, inflation adjusted, has been going steadily down---think about that one!).

Forget the "strategic metals"--WATER is going to be the scarce item of the late-1980's and 1990's. Those of us who live in the Southwest know this already--and the East is finding it out. Unlike electricity, you can't manufacture water, and I have therefore been recommending the water utility stocks. Back in the May 15 report I recommended the following five water stocks: American Water Works (NYSE), San Jose Water (Amex), Consumers Water Co. (OTC), Calif. Water Service (OTC), Southwest Water Co. (OTC). All pay dividends, most are around ten times earnings, and they all have an excellent future. I continue to recommend a package of all five. Buy them for your kids, buy them for your old age. As the population grows, water (not Coke) will be it.

BONDS, RATES: Bonds have been in a trading range ever since May. I think they're going to stay there for a while longer. This Dunn & Hargitt chart (22 N. Second, Lafayette, Indiana) shows the daily action of the September bond futures over the last seven months. The bonds halted their rally just short of 80 in May, fell back to 74 in July, and they have been pushing up ever since--but not to a new high.

On August 29 the Muni bond contract (Sept.) broke out to a new high. The breakout was not confirmed by the weaker T-Bonds. My interpretation: Muni bonds have suddenly turned stronger than T-Bonds, and my guess is that the sophisticated muni bond market is saying that Reagan's new tax bill is not going to make it. If the tax bill is dead, then muni's are a bargain compared with T-bonds. For instance, yields on State of California general obligation bonds are now about 85% of comparable Treasury bonds. The muni's are cheap unless we go into a depression and the Golden State goes belly up. In that case the T-bonds are the winners because Washington can print the paper to pay



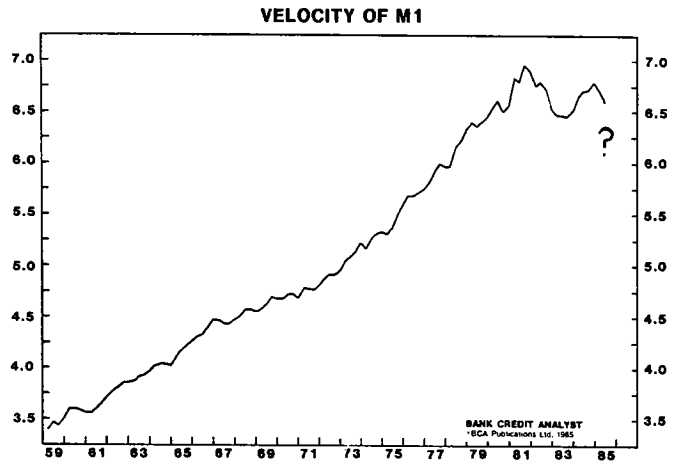
off the bonds--while the Golden State can only raise taxes, cut expenses or scream at its politicians.

GENERAL OBSERVATIONS: On August 23 the CRB Commodity Futures Index dropped to 217.9, lowest level in seven years. The worst performing sector of the Index is the agricultural with the grains and the meats still very weak. If the Commodity Index (27 components including silver but excluding gold) is a barometer of inflation or deflation, I have to conclude that the forces of inflation are now quite dormant. How can gold and the precious metals rise in this kind of environment? They can if South Africa's mines are in danger of closing or if the US banking system is in danger.

Despite "rounding bottoms" and "saucer formations" in gold, the fact is that the metal has not yet bettered its March high, and this in the face of a weak dollar and an explosion in the various foreign currencies. It appears as if the precious metals are CAUGHT in a tug-of-war between the forces of deflation and the inflationary impact of a weak dollar and a booming money supply. The outcome of the battle is still far from clear.

So far, it would appear that the Federal Reserve has been pushing on a string. With M-1 money supply expanding at the annualized rate of 12-14% the flood of money has been unable to spur the economy. Part of the problem may be the steady decline in business activity as portrayed by the drop in money velocity (see chart in last Letter). Money velocity is sinking because individuals and corporations are not turning over their money rapidly. The velocity decline therefore reflects general business sluggishness.

The accompanying long-term chart shows the velocity of M-1 (M-1 money supply divided by GNP). Here we see a pattern different than anything seen in the last quarter century. One explanation could be that a huge chunk of US manufacturing has been exported overseas. Thus US sales hold up--but the US isn't making the products!



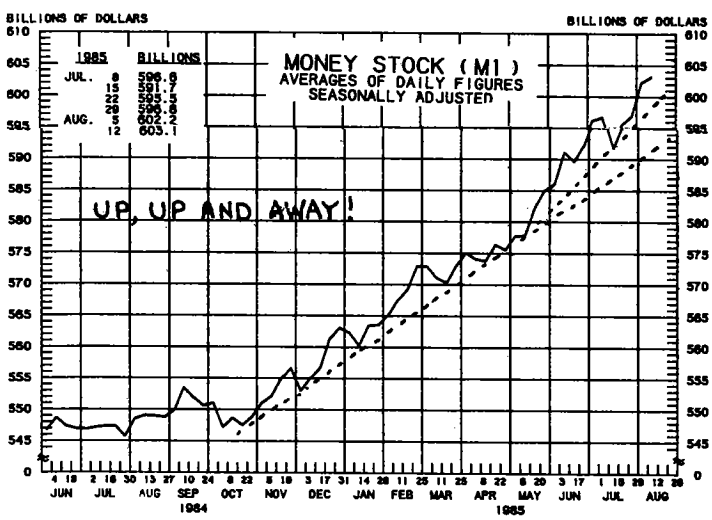
On the plus side of the business equation, corporations are now reliquifying. The huge amount of central bank liquidity is (hopefully) sifting through the system. So in time (if the past is any criterion) this reliquification process should take hold, and a new business boom could result.

Personally, I think this is what the stock market sees as it mills around and under the July highs. It is this gradual reliquification process which I believe will produce (at worst) a bull market correction rather than a primary bear market.

On the very big picture, I think it is remarkable in the face of the wildly climbing M-1 that there have not yet been any real signs of inflation. The kind of deficits we have been seeing in 1985 together with the roaring M-1 figures would have produced 20% inflation and $800 gold five or ten years ago. It is a testament to the creeping forces of deflation that all is quiet in the world of gold, commodities, precious metals and collectibles.

One of the wonders of the current market is the miniscule yield provided by the D-J Transportation Average. At present this yield is just above 2%, the lowest yield in this Average in stock market history. Charles Dow wrote that stocks are very dear when, on average, they yield less than 3.5%. So at 2% my thought is that the Transportation Average is treading on thin ice.

On a strict value basis, it's hard for me to understand why I should buy Transport stocks yielding a taxable



2-3% when I can get a tax-free 8.5% in AAA rated municipal bonds. But as they say, it's differences of opinions that make markets.

MEDIA ORCHESTRATION: The world of journalism must march to some kind of unconscious drum. Of course, selling newspapers (and magazines) can be likened to a variety of show business, because excitement and change and immediacy sell paper--and if you don't sell papers, you don't stay in business.

With it all I find the trends of fashion in newspapers fascinating. For instance, a few years ago the newspapers were frothing over the Iran-Iraq war. Well that war is still going on, but little or nothing about it is written (by the way, what ever happened to Khomeini, remember him?).

Then only last year the papers were beside themselves over the Russian invasion of Afghanistan. Well, that war is still going on, thousands of Afghans are still being starved or killed, and the whole thing has just about disappeared from the newspapers.

The latest headlines concern South Africa. Suddenly, the newspapers are aflame with stories about apartheid, repression in South Africa and what the US must do about it. I'm for the equality of man, but why the sudden interest in S. Africa? Our safe, well-fed liberals parade in front of the S.African embassy, but why not the Russian embassy? After all, Russia still rules its people with an iron hand, Russia still is a flagrant offender of human rights. Why S. Africa? And why suddenly S.Africa?

To me, trying to explain why the newspapers have suddenly jumped on the S.African situation is like trying to explain why the low-priced stocks exploded in 1968 or why the computer stocks blew off in 1984. Don't get me wrong, as I said before, I believe all men are created equal. But equality like treason or capital punishment is a matter of timing. Commit treason in 1983 and its 5 to 10 years in the slammer. Sell secrets to the Soviets next year and it will be the death penalty.

NOTES & QUOTES: This note just received from Dr. M.V. of Manhattan Beach, Cal.). "Went to Soviet Union for three weeks and would highly advise it to anyone who hasn't been to a communist country. They are open to tourists. A great adventure and learning experience. God bless America and capitalism!" (Russell's note: I guess that says it all).

* *

Last week American Telephone announced that it was laying off 24,000 workers. A few days later Ford announced that it would have a gradual lay-off of 10,000 workers. Union Carbide will drop 4,000 workers. What's happening? Just what I have been saying would be happening. American corporations are now living without inflation, and they are not finding it easy. So they are trying to get "lean and mean." And that means cutting back, cutting to the bone, getting rid of dead wood.

All of which has me thinking about an American dinosaur, the US Post Office. I have had to deal with the US P.O. for over a quarter century. During that period my postage costs have risen over 600%. A very major part of the Post Office's expenses is salaries. Salaries in the Post Office are far above comparable

salaries in private industry. I have long advocated turning the Post Office over to private industry, even making it a monopoly like the old AT&T. Can you imagine what would happen? Within a few years probably half the workers would be laid off, the PO would be automated, mail delivery would speed up, and postage costs would probably drop in half. On top of that, the private PO would probably make a huge profit. So my vote is for capitalism--make the PO a business rather than a political boondoggle.

* *

For years people have told me, "Boy, Russell, have you got a racket! Just sitting out there in La Jolla jotting off stuff about the stock market. How do you do it?" And I answer, "Shucks, it's a piece of cake. Have you got some paper and a pencil at home? Why don't you write down your thoughts about the markets and try to sell your report to people around the world. It's easy, and heck, people will just read anything about the market."

So far, none of my friends have tried it. You know, it's strange, but there are about 150 million stockholders in the US, but there are maybe a dozen of us who make a good living out of writing about the markets. Does that tell you something? And now we have a window on the advisory business--the common stock of Value Line (OTC). Value Line stock hit its high at 40 last summer. It is bid around 20 today. But don't worry about your subscription to Dow Theory Letters, because business is still good around here. And I guess I've got more faithful subscribers than most, because the renewal rate at Dow Theory Letters still runs near the highest in the industry (80% renewals over the last 12 months). Thanks, to all of you.

* *

We've got a hotel in downtown San Diego called the US Grant Hotel. The figures here will give you a good idea of what's happened to the dollar in the last 75 years. The Grant was built by U.S.Grant, Jr. in 1910 for a total cost of $2 million (and that included the cost of the land). The Grant was sold recently, and is now being renovated and refurbished. The cost for the renovation will be $80 million. The cost of re-doing the lobby alone will be $4 million, twice the original cost of the whole hotel.

* *

This excerpted piece is from an August 26 article in the New York Times. I'd say it was food for thought:

"In my more cynical moments, I think that the deficit is President of the United States," Sen. Dave Durenberger (R-Minn.) ruminated in a speech in Minneapolis.

"It, more than Ronald Reagan, has and will produce a revolution in the shape of the federal government. . . . And it is not just the programs we are cutting. The deficit has also kept us from doing anything new for a whole decade."

What drives the taxpayer union's Davidson to push for a constitutional amendment is his view that Reagan and Congress will do little more than talk about curbing the national debt. To Davidson, the federal government perceives the deficit "the way a hillbilly looks at a hole in the roof. When the sun is shining, he asks, 'Why bother fixing it?' And when the hailstorm comes, he says, 'It's too dangerous to go out there.'"

* *

In an advisory letter received here last week, the writer (who is obviously a gold-phile) talks about dollars as "worthless pieces of paper without any backing at all." Now hold it, whoa! Theoretically, the dollar may turn out to be worthless sometime in the future. But right now the dollar will buy anything for sale here or in any country in the world. Furthermore, the dollar will buy stocks, bonds, cars, your neighbor's house or a seat on the New York Stock Exchange. So let's not become confused. The dollar is still legal tender in the US and it is the reserve currency for the world. I can understand the advisor's anger at what's happened to the dollar over the last half century, but let's not be irrational. The dollar, theoretically, may not be as good as gold, but your local coin dealer will still sell you pure gold for dollars.

* *

With lotteries springing up in state after state, I wonder if it isn't time for a national lottery, one that would be used to reduce the national debt. Many people are appalled by the new rise in legal gambling. But government gambling is nothing new.

One of the greatest instances of government gambling is the case of Staten Island, an island much closer to New Jersey than New York. But today the Island is part of New York. Why? The Colonial charters of New York and New Jersey left the status of Staten Island in doubt. So after much shouting on both sides, it was agreed to hold a yacht race around Staten Island, the winning state to take title. The race was held, New York won, and Staten Island became part of the Empire State.

* *

BARGAIN? A major no-load fund advertised last week that $1,000 invested in this fund (assuming reinvesting of dividends) would have grown to $2500 over the last five years. That's pretty good. But consider this—the last five years were bull market years with the stock market heading broadly higher. Also, if you are in a high tax bracket the profits ($1500 would be subject to around 50% in taxes) would be roughly $750. So you would end up with $1750 on your original investment.

Now suppose that instead of this fund you had purchased muni bonds from your own state, say bonds yielding 9%. After the same five years (assuming reinvestment of interest) you would have ended up with $1500, and there would be no taxes to pay. You would have ended up with $1500 no matter which way the stock market had gone. Thus the no-load fund's performance would have netted you roughly $250 more than muni-bonds during that five years of bull market.

NEXT MAILING: Sept. 18

GOLD: Maybe the best way to start this section is with an excerpt from my friend Jim Grant's excellent report, "Grant's Interest Rate Observer" (212) 608-7994).

> Despite the latest upheavals in the banking and mortgage markets, the spread between the yields on Treasury bills and those on uninsured certificates of deposits of the nation's largest banks remains narrow—a traditional sign of credit-market confidence.
>
> Wall Street is selling paper, and people are buying it. In free exchange for their labor, the nation's savers are taking mortgage-backed securities, junk bonds, zero-coupon debentures

> and all manner of financial exotica. In free exchange for their cars, Japanese manufacturers are taking American paper money. More than that, they are investing the money in United States bonds, in promises to pay more paper money at some distant date. Will all of this seem terribly lunkheaded to a future generation?
>
> Some days it seems so to us, and we wonder, "How long will people take the paper? When will they stop to ask about the earnings behind the debt, and when will they stop to ask about the guarantees? When will they want objects instead of paper?"

And that, in a nutshell, appears to me the best argument for buying gold at this time. There's a storm of paper and junk debt flooding the nation today. Every time I pick up the WSJ I read about another corporation buying out somebody else for half a billion dollars worth of junk bonds. I mean, it's a paper blizzard, and I can tell you where it's all going to end. It'll end with junk bond defaults on a scale you won't believe.

You know (and I might as well write this here) I consider the Reagan Administration a FAILURE. The number one job, the overwhelming absolutely critical job Reagan had before him when he took the Presidency was to reduce this insane federal deficit. In that Reagan failed miserably. He couldn't have done worse. Now Reagan is sidetracking the issue with his damn fool complicated tax plan. It's tantamount to a guy with cancer putting all his energy into removing a splinter. I guess I've been holding back my anger at the whole Reagan performance. The national debt more than doubled under Reagan, and in my book he has been one colossal failure (but with charisma!).

Enough! Back to gold. Here's the way I see the metal picture. My chart shows daily gold and its 144-day moving average going back to January 1983. In early-April the 144-day moving average flattened out, and I wrote at the time that this was positive for gold. In late-April the momentum index (89-day rate-of-change) broke above 1.00 (bullish) and it has remained above that level (except for a three day drop) ever since.

Then two weeks ago (see last Letter) London gold broke above its April 15 peak of 334.50, and it has held persistently above that level. So we now have gold above its 144-day moving average and the MA is starting to rise (bullish). We also have gold momentum holding above the pivotal 1.00 area, and this means that gold is holding persistently above its price of 89 days ago (bullish).

On top of this, gold (chart not shown) is very close to turning up in relative strength vs. common stocks, and as subscribers know, I consider this to be a necessity for a major gold rise.

Finally, gold is now above its 65-week moving average (which is now 329). Historically, whenever gold has held above the 65-week MA a bull market in gold has been underway. So the current picture for gold is better than anything seen in years, and in the last Letter I turned bullish on the metal. Personally, I have started to accumulate Canadian Maple leaf coins. Adventurers can leverage by purchasing gold futures contracts, but I'm old fashioned, and I like to own what I buy. I'm not greedy--just patient. I do things the old fashioned way--pay cash, put it away--and wait.

I must say that since gold pushed above my much-talked-about 334.50 level, the action has been disappointing. True, gold has held above the 334 point, but that's about it. Yes, I've started buying coins, but I'm doing it gingerly. I'll give the newly labeled "gold bull market" all the time in the world to get going. Those who expect a gold explosion over the next year or so could be in for some exasperating times.

The S.African situation is sad. The winds of change are blowing--almost with hurricane force. The rand has been knocked down at its lowest level in history--34¢. Financial trading was halted in the S.African markets last week. S.Africa has $12 billion in loans (to foreign banks) coming due in the next twelve months, and many of these banks are panicking--they don't want to roll over the loans. Thus the situation is becoming chaotic. I have not recommended S.African shares, and I don't like the picture there. Eventually it will change. The change will be brought on by pressure from S. African businessmen, who are now suffering one of the worst recessions in recent history. Housing prices in S.Africa are very soft, mainly because many are selling out and leaving the country. I don't have a solution for the S.African, but I believe in numbers. When 19 million people (blacks) are unhappy with the way 4.5 million people (whites) treat them, things are going to change. It's simply a matter of time.